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Preparing for inflation, but dubious of growth

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While stocks are [rocketing higher](#) on the hopes of US President Donald Trump's imminent "massive tax plan" announcement, a closer look at investor behaviour reveals an increasing level of concern that he may not be able to deliver on his growth promises.

While [volatility has remained eerily low](#), the divergence between rising inflation break evens – which reflect investors' inflation expectations – and falling US real yields – a proxy for growth expectations – indicate investors expect upside risk to inflation but also downside risk to growth.

"You can see that, post the election, we had spikes in both of those measures, but real yields have come off recently," said Vimal Gor, head of fixed interest at BT Investment Management, during the Portfolio Construction Forum in Sydney last week.

So far this year, five-year real yields have declined by 16 basis points while five-year inflation break evens have risen by 12 basis points. This separation has filtered through financial markets in the form of the [US dollar sliding alongside real yields](#) and [gold, which usually enjoys inflation concerns](#), has surged.

"So what that is showing us is that the market is losing its expectation about Trump having that much impact on growth but fully expects him to be inflationary," Mr Gor said.

JP Morgan analysts expect global inflation to accelerate to a 2.5 per cent pace in 2017, up from a 2 per cent pace last year. However, the acceleration in recent months has been much sharper. The bank estimates prices are tracking at faster than 3 per cent annualised gain in the three months through January.

Pick up in growth

US Federal Reserve chief Janet Yellen [testified to the recovery in inflation in front of US legislators last week](#).

However, while inflation seems fully priced in, investors don't seem completely sold on the notion that growth is picking up.

Recent employment data and survey data out of the US provide some support for a pick up in growth. However, wage growth remains flat and personal consumption expenditure (the US Federal Reserve's favourite measure of inflation) has risen by only 1.6 per cent in 2016.

[Dr Yellen noted](#) that, although this was still below the Fed's 2 per cent target, it was 1 percentage point higher than its pace in 2015.

However, business investment is the crucial factor in determining if the US economy is enjoying a genuine pick up in growth. US industrial production, which measures the output at US factories, mines and utilities, dropped by 0.3 per cent in January from the previous month.

Bank of America Merrill Lynch recently surveyed a number of its clients and found the divergence in inflation break evens and falling real yields stem from a growing pessimism about the Trump administration.

Benefit of doubt

"With many investors having loaded up on Trump trades after the elections, their willingness to continue to give the benefit of doubt to the new administration appears to be wearing thin," said David Woo, rates and emerging market strategist at Bank of America Merrill Lynch.

Nonetheless, investors expect inflation to maintain its upwards trajectory in the short term and, as such, have positioned for a significantly higher inflationary environment.

"This is one part of the market that can do very well in a rising rate environment so it's been an area of focus to us over the past six months," said James Taylor, portfolio manager at AB Global.

"When Trump came in, it acted as a catalyst for us to increase our exposure to inflation linked bonds."

He added: "The outlook on the economic side is relatively constructive, but we are aware there are large event risks coming and this is less about Trump delivering but areas outside of this, such as political risks approaching over the coming months."

This story was found at: <http://www.smh.com.au/business/markets/preparing-for-inflation-but-dubious-of-growth-20170219-gug69k.html>